Christian Noyer: Central banks in the financial crisis

Speech by Mr Christian Noyer, Governor of the Bank of France, at Paris Europlace, Paris, 3 July 2009.

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Introduction

Ladies and gentlemen,

It's a great pleasure for me to address such a distinguished audience.

From the outset, central banks have been major actors in fighting the financial crisis. Overall, their actions have been broadly applauded. In the period to come, however, steering the economy in an environment of high uncertainty will prove particularly challenging. It is therefore timely to reflect upon the past, present and future course of central banks' actions. Today, I would like to address three questions: Is monetary policy responsible for the crisis? How to assess the policy response from the central banks up to now? And, finally, to which extent does the crisis change our vision of their role in the future?

Is monetary policy responsible for the crisis?

To those who think it is the case, the standard argument goes as follows: in the aftermath of the equity bubble that burst in 2000, interest rates have been kept too low for too long. This created, for investors, both an incentive and a possibility to take excessive risk. The incentive came from the low level of interest rate where the "search for yield" could only be satisfied by moving to riskier assets and increasing leverage. The possibility was created by ample liquidity and the availability of cheap financing.

Another criticism of monetary policy owes to its alleged asymmetric response to asset prices. central banks would not *lean* against bubbles, but were prepared to *clean* the consequences after they burst. Investors were thus led to believe that monetary policies would always bail them out in case of trouble. This created a "macroeconomic put" which could only result in excessive risk taking.

I am not fully convinced by those arguments for three reasons:

- First, to the extent that the crisis has been triggered by macro economic imbalances, the causes seem more real to me than monetary. Specifically, low nominal interest rates, between 2002 and 2005, reflected low real interest rates rather than permissive monetary policies. Indeed, when policy rates were progressively raised, in 2004 and 2005, long-term rates did not follow, and the yield curve flattened unexpectedly, creating the famous "conundrum". The abundance of saving in the world, especially in emerging economies, prevented real rates from rising, which both gave rise to capital exports to the US (and the accompanying current account deficit) and exerted worldwide pressure on the long end of the yield curve.
- Second, part of the bubble can be explained by more "structural" factors such as asymmetry in financial development between emerging and developed economies. According to the analysis developed by Caballero and others, the world suffers from an "asset shortage". The supply of liquid and safe financial instruments is insufficient to meet demand, and that supply is asymmetrically distributed across the world. As the US is the primary supplier of liquid and safe assets, it attracts inflows of capital, a process which accentuates global imbalances. Excess demand for those assets pushes their prices up, which triggers financial bubbles. Financial development in surplus countries would go a long way to solve that problem by reducing the asset shortage, thus the probability of future bubbles.

- Third, there is no denying that weaknesses and failures in financial markets played a major role in the build up to the crisis. Over the last decade, financial innovation has been organized to "transform" illiquid and risky instruments into (apparently) safe and liquid assets. That unsustainable process has abruptly come to an end with the burst of the credit bubble. During that period, rating agencies, accounting rules, unregulated and off balance sheet entities as well as very poor risk management all contributed, willingly or unwillingly, to fragilize our financial systems. Those weaknesses are at the origin of the crisis. Had they been addressed in due time, most of the problems we are now dealing with could have been avoided. Creating a new regulatory regime and strengthening our supervisory arrangements are at the forefront of efforts conducted at the national and, for the EU, at the European level. Those efforts are closely coordinated worldwide through the G20 process and the newly created Financial Stability Board.

Central banks' response to the crisis

History taught us that banking crises degenerate into deep and lasting depressions unless they are dealt with quickly and forcefully. Those lessons were not lost on both fiscal and monetary authorities and the policy response worldwide has, indeed, been exceptional by any historical standard. I would like to focus here on three characteristics of central banks interventions

- First, they have been fast and decisive. Indeed, the start of the crisis can be dated back to August 9 2007, when the Eurosystem provided up to 95 billion euros in exceptional liquidity support to the interbank market. As the crisis developed, those interventions multiplied and evolved, a point to which I will return shortly. The deterioration of the real economy and subsequent easing of inflationary pressures opened room for a substantial relaxation of the monetary policy stance. In the euro area, seven reductions in policy rates brought the interest rate on our main refinancing operations from 4.25% in October 2008 to 1% today.
- Second, those interventions have been flexible and highly innovative. Central banks saw as their mission to avoid the paralysis of financial intermediation and keep the monetary transmission mechanisms working efficiently. To achieve those objectives, they considerably expanded and diversified their tools and instruments. In countries where markets play an important role in the allocation of credit, they created numerous new facilities to provide financing and to lower spreads through the purchase of private and public debt securities. In the euro area, where banks are dominant, interventions were designed to ensure that adequate liquidity would flow into the system without obstacles or restrictions. It has become commonplace to talk about those measures as "unconventional" and, indeed, they are. The important point, however, is that they do not substitute, but complement "conventional" movements in policy rates and can be implemented in parallel. In other words, there is no need to wait for policy rates to reach zero (or any "lower bound") to innovate in the design and implementation of monetary policy. For the Euro area, the most important shift took place in October 2008, when the Governing Council decided to allocate liquidity to banks in unlimited amounts at the policy rate. Although it was not advertised as such at the time, this apparently technical measure deeply transformed the policy framework and marked the move into unconventional territory.
- Third, those interventions have been remarkably cooperative and convergent. The largest coordinated reduction in interest rates in history took place on 8 October 2008 with the participation of seven major central banks. A dense network of bilateral swap agreements has insured that liquidity shortages in international banking and financial markets can be addressed speedily and efficiently. Finally, as the crisis triggered a synchronized slowdown in activity and inflation worldwide, monetary policy rates have

converged to low and comparable levels. Remaining differences can be explained by slight differences in economic prospects and financial systems. Monetary conditions are almost identical: three and six months Libor and Euribor rates do not differ by more than 50 basis points.

I strongly believe that those three features – speed, innovation and cooperation – allowed central banks to play a decisive part in containing the crisis and limiting its impact.

Has the crisis changed our vision of central banking?

The credit bubble has already extracted heavy costs on our economies and the welfare of our citizens. All must be done to avoid the repetition of such developments.

Bubbles are however complex phenomena: hard to detect, hard to prevent, hard to fight. Can we do better in the future and what contribution can central banks bring ?

The crisis has revived the old, but ongoing, debate on whether monetary policy should aim, or not, at ensuring financial stability in parallel to its main objective of price stability. The arguments are well known, on both sides. New ideas are being brought, regarding, in particular, the impact of monetary policy on overall maturity transformation and leverage inside the financial system. It is desirable and healthy that this discussion takes place. Let me give you my own reflexion, at this stage:

- The primary and dominant objective of monetary policy should remain price stability. Any dilution of this fundamental mandate would be take us back three decades and be extremely detrimental to our welfare and prosperity in the long run.
- Without prejudice to this primary objective, all mandates allow for consideration of other objectives. Looking at our experience over the last decade, there is a good case for bringing financial stability higher in our priorities. That may imply, in particular, that, when assessing the economic and financial environment, central banks should take a longer term perspective and be more alert to incipient financial imbalances.
- I would note, in passing, that the Eurosystem is well equipped to take such a perspective. Our "two pillar "approach allows us to look permanently at the dynamics of money and credit aggregates, which are essential to detect both long term risks to price stability and potential threats to financial stability.
- But more should be done. It is now broadly accepted that a "macro prudential" approach should be taken when implementing financial supervision. That means looking both at system wide implications of our prudential decisions and their impact on financial imbalances and the real economy.
- Central banks have a major role to play in this process for four reasons: (1) they have an incentive to act, since well functioning financial markets are essential for the transmission of monetary policy; (2) being equipped to permanently look both at financial markets and economic cycles they may have an informational advantage in analyzing their interaction; (3) there independence allows them to produce dispassionate and candid assessments of risks; (4)and, finally, their proximity to the banking system provides them with an intimate knowledge of financial dynamics. Indeed, one of the main lessons of the crisis may be that those countries where central banks assume banking supervision took advantage of their ability to react quickly and flexibly to emergency situations.

Obviously, for macro prudential supervision to succeed, all actors involved – regulators, central banks, national Treasuries and fiscal authorities – will have to closely work together. Amongst plans being floated or decided, it is notable that central banks have been assigned the function of systemic risk supervisor.

Conclusion

Let me now conclude. All major financial crises in history have led to revisiting and redefining the role of central banks. This one is no exception. Central banking will not be the same after the crisis. It is important, however, that changes that will occur do not impact on their ability to reach their primary objective. Price stability may not be a sufficient condition for financial stability. But it is certainly a necessary one. Central banks have to enrich their role and expand their functions for the benefit of general welfare and prosperity. In that process, they will remain guardians of the integrity and stability of money, which is a cornerstone of the social contract in our democratic societies.

Thank you.